How can CFOs cut expenses to ride out the downturn while getting ready to pursue growth?

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Financial institutions (FIs) are navigating the toughest leadership test of a generation. With the US economy on ‘pause,’ and an impending wave of defaults, asset withdrawals and business interruption insurance payouts, it is imperative for FIs to rapidly cut expenses and build reserves. However, FIs should also adjust to the operational challenges brought on by significant increases in remote working, and mobilize to manage spikes in COVID-19-related volumes (e.g., small business loans, revolving credit facility utilization and forbearances). Finally, FIs should be ready to quickly pivot back to fostering the growth agenda when the ‘whatever-it-takes’ monetary policies of central banks open opportunities for profitability.

With the economy facing an extraordinary range of outcomes, CFOs are called to simultaneously cut expenses while preparing to foster growth.

Matteo Polvara, Ernst & Young LLP

In March 2020, in response to the biggest health threat of our generation, the US hit pause on arguably the strongest economy in its history. What followed was a free fall of the major economic indicators to levels unseen since the Great Depression. More than 40 million Americans filed for unemployment, wiping out in less than six weeks all jobs created since 2009.[1] The US gross domestic product is projected to contract by as much as 40% in the second quarter.[2] On the other hand, the Federal Reserve has demonstrated aggressive and open-ended liquidity support for the economy. The epic *battle* between unlimited Fed response and economic shutdown is creating uncertainty on the economic resumption, with possibilities spanning from a rapid "V" shape recovery to a "bad recession"[3] that will last until 2022.[4] Financial institutions are recognizing the need to rapidly cut expenses to withstand the worst economic scenario while avoiding being caught unprepared in the event of a more optimistic recovery.

In contrast to the great recession of 2008, FIs are in far better financial shape.

Regulations implemented and actions taken over the last decade have bolstered balance sheets and strengthened capital positions. FIs' efficiency ratios improved from 61.91% to 56.70%[5] between 2014 and 2019, even if many institutions still struggle to generate a return on capital above its cost. Low price-to-book multiples for FIs indicate that the market has limited trust toward future profitability. Contrary to 2008, central banks have reacted immediately and have begun cutting target interest rates to near zero, purchasing government and mortgage-backed securities, and establishing repo facilities to maintain adequate liquidity within the financial system.[6]

However, the outlook is negative.

Banks are rapidly increasing reserves[7] in anticipation of an impending wave of defaults; insurance firms may be liable to cover for business interruption;[8] auto insurers are providing consumers with relief by offering premium refunds;[9] and wealth and asset management firms are facing a high level of asset withdrawals from clients.

FIs should improve their decision-making and incorporate advanced profitability insights.

FIs need to understand the real profitability of their business and product mix in order to enable portfolio optimization; understand cost dynamics in the event of product and business exits; and surgically target investment on product, customer acquisition and retention to protect stakeholder value and the institution's role within communities.

FIs are finding themselves on the heels of a decade where the preponderance of their investment spend has been absorbed by regulatory-driven projects, or top-tier strategic priorities like cybersecurity and advancing the digital agenda.

Upping profitability analytics and strategic cost management capabilities has often been left on the back burner; as a result, several common barriers exist.

Technology is outdated and overly patched.

Many institutions run their profitability and cost allocation processes through technology that is 10 to 15 years old, runs on premises, and has a significantly higher maintenance and total cost of ownership than cloud-based alternatives. These technology platforms often reflect outdated requirements; are hindered by legacy design compromises; and miss out on the latest technology advances, such as in-memory computation, data virtualization and user-friendly interfaces. As a result, most finance teams have to rely on IT service tickets to run the process on a business-as-usual basis and experience suboptimal performance (e.g., two–three days processing time and the inability to preview results or run what-if simulations) that are simply inadequate with the current pace of events.

There is a proliferation of stand-alone models rather than one integrated and consistent enterprise lens.

Institutions typically run bespoke profitability models at the line of business or business unit level that operate without common dimensionalities and enterprise-wide agreement on common definitions. This is often true for even the most foundational elements, such as the definitions of products and customers. Data management, driver definition and data provisioning are also frequently executed in silos. As a result, many organizations face common challenges in forming an enterprise-wide profitability profile, which makes it challenging to determine the most profitable allocation of scarce resources (e.g., liquidity, investment spend and working capital). In addition, these legacy barriers divert resources into performing duplicative activities and continuous reconciliations.

Finance transformation projects have often been considered discretionary and relegated to a lower priority in the allocation of internal investment funding.

Following the aftermath of the 2008 financial crisis, most FIs had to adjust to a rigorous wave of new regulatory requirements, and secure funding to advance the digital agenda, given market dynamics and pressure from new FinTech players. As a result, demand for improving costing and profitability capabilities is unmet, and now, what has always been ascribed as hypothetical, outlier stress scenarios is a hard reality filled with persistent uncertainty.

> *FIs need to modernize their profitability capability to identify actionable cost-cutting levers; optimize their product and business mixes; and isolate which products, customer segments and markets to continue investing in while awaiting the economy recovery.*

The playbook for advanced profitability insights

Avoid harming profitability while playing defense

Avoid unintended consequences while considering discontinuing products and/or business exits via analyzing margin contribution and economic value.

Model cost dynamics and estimate impact of business events

Enhance profitability models to enable "what-if" scenarios to estimate the impact from business events and material variation in volumes.

Drive consistency through a subscription-based approach

Strike the balance between driving standards and providing leeway to maintain customized analyses in order to achieve consistency without sacrificing adoption.

Finance on demand

Optimize the technology architecture and leverage cloud services with user-friendly interfaces to enable finance to execute the process free of IT service tickets.

In data we trust

Build demonstrable trust, evidencing capabilities, and confidence into the data supply chain by creating traceability from P&Ls back to the general ledger.

Bolster data supply chain

Leverage the latest data platforms to truncate the data supply chain and avoid unnecessary reconciliations and physical movement of data, unless it's necessary.

Embed profitability insights into day-to-day business processes and decision-making fabric

Couple investments in technology and profitability capabilities with organizational change and training to integrate insights within the decision-making fabric.

Avoid harming profitability while playing defense

- **Compute product contribution margin to understand how each product offset enterprise fixed costs**
- **Use what-if scenario analyses to estimate the impact of changes in business and product mix**
- **Complement accounting profitability views with insights into economic value**

As financial institutions rush to play defense in an attempt to cut expenses and to reserve capital, they should avoid three common pitfalls: discontinuing products that are positively contributing to absorb sunk and fixed costs, trigger unintended hits to other products' profitability due to stranded costs and, finally, omitting to weigh in considerations on a product's economic value while assessing the opportunity to discontinuing it.

Products with positive contribution margin, even if they are unprofitable overall, present the opportunity to offset overhead and infrastructure costs that would otherwise be reallocated to other products, hindering their own profitability. In fact, expanding the sales volume for products that are unprofitable but preserve a positive contribution margin will improve the FI's bottom line. For that reason, it is important to create margin analyses that are consistently available across the product portfolio.

Discontinuing a product or exiting a business may cause two additional unintended consequences. First, a significant portion of the supporting costs may not cease to exist within the cost structure following the interruption of the business or product they supported (i.e., stranded costs). Secondly, capitalized expenses might convert to operating expenses and affect the current fiscal year income statement. The conversion occurs because the capitalized expenses may now be considered to be impaired if there is a question around the ongoing useful life of the asset(s)/software.

Finally, the optimization of a product and/or business mix cannot be severed from the understanding of the economic value, or in other words, of the benefit provided by the product or business to the enterprise. For example, recently, many asset management institutions have witnessed a steep decline in the profitability of their brokerage accounts following commission-free trades. However, when cash sweeps and the opportunity to cross-sell advisory services are taken into consideration, these products are proven quite valuable for the firm.

> *Oftentimes, discontinuing a product or a business may carry unintended profitability deteriorations due to impacts related to accounting rules, cost dynamics and loss of economic value. Institutions should enhance their profitability models with what-if scenario analyses capable of estimating these impacts.*

Model cost dynamics and estimate impact of business events

Add cost dynamics to what-if scenario analyses to model changes in profitability triggered by business events and material changes in volumes

In the midst of a global pandemic with the economy on life (and Fed) support, and with the Coronavirus Aid, Relief, and Economic Security (CARES) Act appointing financial institutions as the conduit for the relief, multiple scenarios are at play to forecast business volumes and to estimate related consequential effects on profitability.

What-if scenario capabilities need to be improved to help generate profitability insights addressing situations like the loss of a large client, increase of volumes due to administering public relief, or estimating unused capacity that can be deployed to bolster growth or manage volume spikes.

To enable these capability analyses, costs need to be tagged as variable, fixed or fixed-step at the general ledger account level, and the categorizations need to be retained throughout the cost lineage.

The preponderance of a financial institution cost base is neither fixed nor variable. It is "fixed-step." Fixed-step costs are a hybrid that behaves upward like a variable cost, augmenting when volumes increase beyond a certain threshold. However, costs increase in increments, and once incurred, they behave like fixed costs that will not decrease with volume reductions.

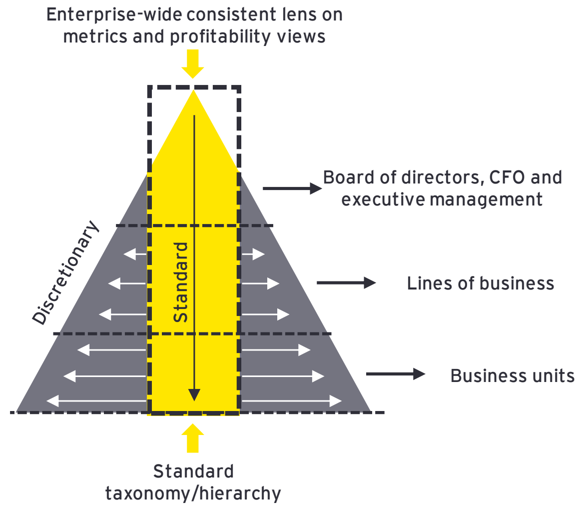
Drive consistency through a subscription-based approach

Set a consistent enterprise lens on profitability to optimize allocation of resources

Use a subscription-based approach to drive standards without sacrificing adoption and buy-in

Most FIs rely on a proliferation of custom profitability models that are designed to meet narrow use cases rather than offering a consistent and comprehensive view across the enterprise. Many institutions are finding that cascading a common standard is an impervious battle for consensus. These efforts are often abruptly aborted or forcefully implemented, and they often result in the insurgence of shadow accounting.

To obviate to the problem, EY suggests utilizing a subscription-based approach, which consists of seeking enterprise-wide agreement on a standard hierarchy/taxonomy (e.g., product hierarchy, service/activity catalog) at an agreed-upon level of granularity, and typically up to two levels are included. No deviation from this hierarchy/taxonomy is permissible; however, each business unit can electively opt in to the select portions of the hierarchy/taxonomy that are relevant to their own business (i.e., they subscribe to it) without the need to adopt the entire hierarchy. They maintain full discretion to build additional levels of granularity without the need to adhere to the corporate standards, as long as they commit to reconcile the expanded hierarchy/ taxonomy back to the enterprise-wide view.



Finance on demand

- **Enable finance to run the profitability process through a user-friendly interface**
- **Compute results within seconds and enable scenario planning interactive sessions**
- **Leverage the latest technology advancements, such as cloud, in-memory capabilities and data virtualization to reduce data latency and support the finance-run portion of the process**

Antiquated legacy systems are a common barrier to the generation of profitability insights and modeling of cost-dynamic scenarios. Often, FIs are heavily relying on their technology group to run the business-as-usual process, often requiring IT service tickets to be opened for recurrent items like changing a driver or updating the activity catalog. Many current systems are outdated and overly patched, which can cause processing times to range between one and three days.

Operating within an uncertain economic environment requires FIs to run multiple profitability and planning scenarios. Imagine having to wait one to three days without previewing interim results and, for any subsequent scenario adjustment, having to open another IT service ticket and wait an additional one to three days.

FIs should modernize their capabilities to take advantage of the latest technology advances, such as cloud, in-memory capabilities and data virtualization. This allows finance teams the flexibility to run their portion of the process through a user-friendly interface, preview results instantaneously, and make changes to the computation rules and drivers.

FIs should avoid forcing a single tool to be the one-stop shop, but rather focus on a comprehensive system architecture where each tool is working in synergy across each phase of the process (e.g., driver data preparation, allocation engine, including what-if scenarios, reporting and analytics), and create the right partnership and division of responsibilities between finance and technology.

> *Finance teams need to run the process through a user-friendly interface; be able to hold collaborative cross-teams scenario planning working sessions with the ability to preview results instantaneously; and rely on their technology function for data preparation, quality and governance.*

In data we trust

- **Enable traceability of cost and revenue from a P&L line item back to the general ledger**
- **Simplify the flow of cost and revenue data to include the least possible number of steps**
- **Establish auditable financial controls across the cost and revenue lineage**
- **Evidence capabilities that are associated with regulatory mandates**

Unless there is a broad acceptance of, and trust in, the data, organizations will not be able to move away from internal disputes, shadow accounting and never-ending reconciliations, which hinders the discussion of profitability insights and available levers.

Modern technology offers the ability to visualize the end-to-end flow of transactional and business events that are the genesis of cost and revenue data, providing a means for finance and business users to attest to the veracity of the financials.

> *The entire profitability lineage should be traceable, auditable and supported by a series of robust financial controls from the point of origin to reporting dimensions. Finance and business users need easy access to this type of traceability to buy into enterprise-wide profitability data.*

Bolster data supply chain

- **Integrate data from multiple systems, curate and make it easy to access in a consumable, self-service oriented manner**
- **Model select data at the point of use (e.g., a dedicated data layer) rather than modeling all data all the time**
- **Truncate the data supply chain to reduce reconciliations and physical movement of data**
- **Focus should not be on one do-it-all tool, but rather on a comprehensive architecture that solves for methodology and workload issues**

The advent of nimble cloud-based tools where complex calculations can be performed within seconds has created the misconception that setting up a profitability platform is easy and quick, and can be done directly by finance users. While finance is undoubtedly taking the shackles off with regard to a large portion of the process, the technology function should continue to lead the way with regard to setting up a truncated data supply chain, where large data is collected from multiple sources, cleansed, contextualized and made consumption-ready. Once data reaches the cloud-based data hub, finance users will be able to instantaneously run complex computations and what-if scenarios thanks to in-memory capabilities. However, overlooking the data supply chain is a recipe for suboptimal system performance and cloud sizing issues.

Embed profitability insights into day-to-day business processes and decision-making fabric

- **Make organizational changes alongside technology modernization to improve return on investment and boost adoption**
- **Incorporate profitability insights within key finance and business processes**
- **Train executives and managers on how to use insights to augment their day-to-day processes**

FIs need to couple investments in advanced profitability insights with organizational change and training to drive adoption and gain the upper value of the transformation. This can be accomplished by embedding insights and data-driven analytics into day-to-day processes and the enterprise decision-making fabric. To succeed, FIs need to provide consumption-ready data to finance and business users in conjunction with tools with user-friendly interfaces. Profitability insights should also be used for reward and performance management purposes, provided that a traceable data lineage can be instituted to build trust in the data itself.

Ten profitability questions that each CFO, finance and business leader should be able to answer in order to lead through these times of uncertainty and heightened risk:

1. How is each product and/or customer contributing to the overall profitability?
2. What is the margin contribution and the economic value of each product?
3. What part of a product and/or business cost base is likely to remain stranded within the organization pursuant to a product/business exit?
4. How relevant is each product in relation to the value mix of the most profitable customers?
5. What are the most immediate opportunities for cross-sell/upsell within the existing customer base?
6. Which cost-cutting opportunities are immediately actionable and will not harm growth (e.g., variable costs that are related to discretionary activities, and for costs that have not yet been committed into a financial plan)?
7. How does the loss of a large customer impact the overall profitability of the enterprise, and does it affect the profitability of other customers?
8. How does the organization maximize the return on investment for initiative spend?
9. Is the technological enablement of the profitability insight capability geared to maximize operational efficiency?
10. How does a change in macroeconomic variables affect enterprise-wide profitability?

What financial institutions should do now, next and beyond

Perfection is the enemy of profitability. Most FIs are currently capturing only a fraction of the potential value from profitability insights. Organizations that are investing in harnessing these capabilities will create a competitive advantage and a differentiating value within the industry, while those that do not will face an increasing headwind. The unprecedented economic and market dynamics triggered by the pandemic will soon separate institutions between the "best" and the "rest." FIs should act now to enhance their profitability insights. However, with aging data and technology platforms and a decade of minimal investment in these capabilities, many institutions may struggle to find a viable path forward that delivers the immediate results they urgently need, while progressing toward a sustainable profitability ecosystem, and generating the broader consensus on a changing role and responsibility between their finance and technology functions.

> *Organizations need to focus on outcomes, rather than mechanics, as they build tactical reports that make better sense of existing data. The output should be used to guide the path toward a sustainable "engine room" where profitability insights are generated efficiently and are embedded within the decision-making fabric of the organization.*

Now *Make better sense of existing data*	**Next** *Build a sustainable ecosystem*	**Beyond** *Adopt innovative growth drivers*
▸ Articulate use cases and business decision-making needs ▸ Produce tactical profitability reports based on readily available data and existing tools ▸ Outline the target state vision and gather business requirements ▸ Seek consensus on the way forward	▸ Agree upon technology architecture and roles between technology and finance ▸ Expand data generation and aggregation to address use cases ▸ Optimize the data supply chain ▸ Embed insights into processes and management routines	▸ Ingest additional data from internal systems and external sources ▸ Leverage artificial intelligence and machine learning to create data-driven analytics and business insights ▸ Track adoption with performance indicators

If you are looking to harness differentiating profitability capabilities, and you want to be effective out of the gate, or you simply want to hear about how we are helping leading FIs build insight-driven competitive advantage, please connect with our team.

In closing

COVID-19 proved that macroeconomic events can change faster than most FIs' modeling capability can keep up with. The pandemic has afflicted financial institutions compounding on their *pre-existing conditions*, such as antiquated technology, silo models that prevent consistent enterprise views, data latency causing models to run with data that often has at least a one-month lag, and the lack of user-friendly interfaces available to finance analysts to run instantaneous scenario analyses.

CFOs should look at COVID-19 as a wake-up call and invest in advanced profitability insights. Insights should be embedded within the decision-making fabric of the organization in order to instantaneously react to business and economic events as well as simulate the impact of upcoming scenarios and proactively prepare for them.

With investment budgets being reduced and non-essential change initiatives being delayed, FIs cannot proceed by trial-and-error and should be effective out of the gate in the creation of advanced profitability insights that yield immediate results, while, at the same time, advancing the broader profitability modernization agenda.

Matteo

Matteo Polvara, Ernst & Young LLP
New York, July 1, 2020

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Successful organizations are investing in creating “finance on-demand.” A comprehensive architecture with a shortened and effective data supply chain, and cloud-based systems that, thanks to their user-friendly interfaces, enable authorized users to run instantaneous analysis and create strategic business insights based upon a broad set of curated and high-quality data.

Steve Krueger, Ernst & Young LLP

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Leading FIs view the generation of profitability insights not as one-off initiatives, but rather as the perpetual optimization of the finance process. This optimization is anchored by investments in technological enablement of core business processes and in data management capabilities. Those efforts yield strong efficiency results in ‘straight-thru-processing,’ the streamlining of the data supply chain, detailed capture and robust management of metadata, and aid the business with the creation of rich business semantic layer for self-service analytics.

Geoff Burkholder, Ernst & Young LLP

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Today’s volatile market environment, when combined with advancements in data management and cloud-based technologies, has blown the doors off of the “old guard” profitability reporting regime. Dynamic modeling of business drivers, reporting of atomic client level profitability, and calculation of marginal cost behavior calculations are all the “new norm” for our finance business partners.

Steve Bopp, Ernst & Young LLP

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Matteo has more than 15 years of experience in consulting, and he is dedicated to helping clients solving business problems that are impediments to advances of the broad finance agenda. Matteo specializes in profitability and management reporting, and he is passionate about blending finance and technology to increase the certainty of outcomes and sustainability of change initiatives, leveraging EY alliances.

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The allocation game: managing cost before money is spent

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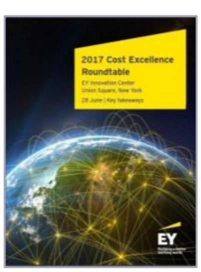

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Key takeaways from EY-hosted roundtable on cost excellence practices and participations from cost management specialists across large FIs

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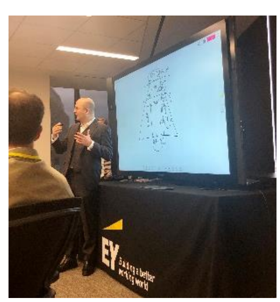

Email matt.polvara1@ey.com for registration

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